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In the Supreme Court of the United States

OCTOBER TERM, 1941

No. 136

BADGER OIL COMPANY, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the United States Board of Tax Appeals (R. 27–39) is reported in 42 B. T. A. 521. The opinion of the United States Circuit Court of Appeals for the Fifth Circuit (R. 143–148) is reported in 118 F. (2d) 791.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered April 8, 1941 (R. 149). A petition for rehearing, filed April 28, 1941 (R. 150), was denied on May 10, 1941 (R. 157). The petition for

a writ of certiorari was filed on June 6, 1941. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

The taxpayer acquired by assignment an oil and gas lease. Subsequently, the taxpayer acquired the fee title to the property and approximately two-thirds of the lessor's royalty interest. In the taxable year, the taxpayer reassigned the lease for a cash consideration. The question presented is whether this cash consideration is subject to percentage depletion under Section 114 of the Revenue Act of 1934.

STATUTES AND REGULATIONS INVOLVED

Revenue Act of 1934, c. 277, 48 Stat. 680:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME.
>
> In computing net income there shall be allowed as deductions:
>
> * * * * *
>
> (m) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. * * * (U. S. C., Title 26, Sec. 23.)

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

* * * * *

(b) *Basis for Depletion.*—

* * * * *

(3) *Percentage Depletion for Oil and Gas Wells.*—In the case of oil and gas wells the allowance for depletion under section 23 (m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. * * * (U. S. C., Title 26, Sec. 114.)

Treasury Regulations 86, promulgated under the Revenue Act of 1934:

Art. 23 (m)–4. *Computation of depletion based on a percentage of income in the case of oil and gas wells.*—Under section 114 (b) (3), in the case of oil and gas wells, a taxpayer may deduct for depletion an amount equal to 27½ per cent of the gross income from the property during the taxable year, but such deduction shall not exceed 50 per cent of the net income of the taxpayer (computed without allowance for depletion) from the property. (For definitions of "gross income from the property" and "net income of the taxpayer (computed without allowance for depletion) from the property," see article 23 (m)–1 (*g*) and (*h*).) In no case shall the deduction computed

under this paragraph be less than it would be if computed upon the cost or other basis of the property provided in section 113.

Art. 114–1. *Basis for allowance of depreciation and depletion.*—The basis upon which exhaustion, wear and tear, obsolescence, and depletion will be allowed in respect of any property is the same as is provided in section 113 (a), adjusted as provided in section 113 (b), for the purpose of determining the gain from the sale or other disposition of such property, except as provided in article 23 (m)–3, relating to depletion based on discovery value, in article 23 (m)–4, relating to percentage depletion in the case of oil and gas wells, and in article 23 (m)–5, relating to percentage depletion in the case of coal mines, metal mines, and sulphur mines or deposits.

STATEMENT

In 1921 T. D. Lewis and his wife, Vida M. Lewis, executed an oil and gas lease to J. B. Martin, covering 2,269.76 acres of land in Hutchinson County, Texas, and 640 acres in Carson County, Texas. The lease reserved to the lessors a royalty of one-eighth of oil and gas produced (R. 28).

In 1926 the Badger Oil Company acquired by assignment the rights of J. B. Martin in 1,321 acres of the original lease, of which 250 acres were in Carson County, and the remainder in Hutchinson County (R. 28).

In 1928 the taxpayer assigned to the McIllroy Oil Company 120 acres of the leasehold in Carson County. The consideration for that assignment was the agreement by the McIllroy Oil Company to pay to taxpayer $18,000 out of oil and/or gas, if and when produced and saved from the land (R. 28).

In 1930 the taxpayer acquired by assignment from Paul and Weatherly the lease on 126 additional acres in Hutchinson County out of the original lease from T. D. Lewis and wife to J. B. Martin (R. 29).

At various times prior to April 17, 1934, T. D. Lewis and wife conveyed to persons not involved herein approximately an undivided one-third interest in the oil, gas, and minerals and the right to receive royalties (but not the right to receive rentals or bonuses from future leases), as to the lands leased to Martin and subject to the lease to him (R. 29).

On April 17, 1934, Vida M. Lewis and the heirs of T. D. Lewis, for a consideration of $40,000, executed to the taxpayer a warranty deed to all of the lands in Hutchinson County which had been covered by the lease to J. B. Martin. The deed did not cover the lands in Carson County, which were subject to the lease to Martin. In addition to the usual terms of conveyance, the deed contained the following language: "It is our intention to convey all of our interest of every kind and nature what-

soever in and to the above lands, including all of our interest in and to the minerals, rents, and royalties therein" (R. 29).

On February 1, 1935, the taxpayer and the International Petroleum Company executed a contract providing for the sale by taxpayer to International of (1) the leasehold acquired by the taxpayer in 1926, except the 120 acres conveyed to McIllroy Oil Company; (2) the unpaid portion of the $18,000 oil payment payable to the taxpayer from the McIllroy Oil Company, and (3) the lease on 126 acres in Hutchinson County acquired by the taxpayer in 1930 from Paul and Weatherly. The contract provided, *inter alia,* for the execution and delivery by the taxpayer of: (a) An assignment of the oil and gas lease to Martin so far as assigned to the taxpayer and covering lands in Hutchinson and Carson Counties, Texas, except the 120 acres which had in 1928 been assigned to the McIllroy Oil Company; (b) the unpaid portion of the $18,000 oil payment; (c) a bill of sale from the taxpayer to International covering personal property in Hutchinson and Carson Counties, Texas, having connection with the leases assigned from taxpayer to International (R. 29–30).

The contract between the taxpayer and International (R. 103) refers to the taxpayer as "Seller" and International as "Buyer." This contract provided as follows (R. 103):

> Seller agrees to sell, deliver, assign and convey and Buyer agrees to buy for the con-

> sideration, upon the terms and subject to the provisions hereinafter stated, the following described real and personal property * * *.

The contract recited (R. 105) that the consideration agreed to be paid for the oil payment and the oil and gas leasehold was the sum of $305,000, and that the consideration agreed to be paid and received for the personal property was the sum of $60,000, which total consideration of $365,000 was to be paid in cash to the extent of $200,000 and the balance of $165,000 in notes of the buyer to be secured by a deed of trust upon the assigned property. The entire recited consideration of $365,000 was actually paid in cash during the taxable year (R. 38).

Before the Board, the taxpayer claimed depletion at the rate of 27½% upon $305,000. In the court below, the taxpayer conceded that as to the 130-acre lease in Carson County, of $650 value, and as to the unpaid portion of an oil payment of $2,000 value, it could not maintain its position. The sole question before the court below was whether the Board correctly denied the taxpayer a depletion allowance with respect to its resale of the 1,321-acre lease (the "Martin" lease) to the McIllroy Oil Company in 1928.

The court below (R. 143–148) approved the action of the Board in treating the cash payment of $305,000 as purchase money rather than as advance royalty; and, therefore, denied the tax-

payer any depletion deduction with respect to that payment.

ARGUMENT

The taxpayer was the owner of the "Martin" lease. It sold the lease for a cash consideration, reserving in the contract of sale no interest whatever in the leasehold. The proceeds of that sale therefore represent the consideration derived from the disposition of a capital asset rather than "royalties" or the like against which depletion is allowable. *Helvering* v. *Elbe Oil Land Co.*, 303 U. S. 372; *Anderson* v. *Helvering*, 310 U. S. 404. The court below followed its earlier decision in *Commissioner* v. *Fleming*, 82 F. (2d) 324, which was apparently approved by this Court in the *Elbe Oil* decision. See 303 U. S. at 374.

Petitioner's sole attempt to escape the consequences of this result rests upon the fact that it had meanwhile acquired various reversionary interests in the oil property. But it had not acquired the entire reversion, for one-third of the royalties originally reserved by the lessor continued to remain outstanding in adverse hands. Accordingly, petitioner had two distinct interests in the property: one, a leasehold, and the other, a portion of the reversion. And the fact that it owned a portion of the reversion, entirely separate and apart from the leasehold, cannot render inapplicable the principles recognized in the foregoing decisions.

The decision below is not in conflict with the numerous decisions of this Court cited by petitioner (Pet. 5). *Palmer* v. *Bender*, 287 U. S. 551, is perhaps the closest of the cases cited, and it involved a lessee which transferred a portion of its leasehold for certain fixed amounts as well as a one-eighth royalty interest in all the oil to be produced. This Court held that in those circumstances, the lessee-transferror still retained an interest in the very portion of the leasehold transferred, and that the payments received were not to be treated as payments for the sale of a capital asset. Similarly here, to the extent that the taxpayer stepped into the shoes of the original lessor and thus received royalties from the new assignee, those royalties would form the basis for a depletion allowance. But the payments here involved were not of that type: The taxpayer, *as lessee,* sold the lease outright. It is merely fortuitous that the taxpayer also had another and wholly independent interest in the reversion.

The further assertion by the petitioner (Pet. 12) that the decision below is probably in conflict with applicable local law, as to rules of property, furnishes no basis for the issuance of the writ. Under the facts of this case, the lease in question could not merge with the subsequently acquired fee because of the outstanding adverse interest in the lease and because of the obvious intention on the part of the taxpayer that there should be no

merger. The taxpayer's interest as lessee under this lease was the property with which we are here concerned and its entire interest as such lessee was sold for a cash consideration, which had no relation to oil to be produced and accordingly furnished no basis for the use of the percentage depletion deduction.

CONCLUSION

The decision below is correct. There are no conflicts. The petition should be denied.

Respectfully submitted.

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